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SUBJECT: UKRAINE: Rada Reviews Natural Gas Sector; Allows Price Rise for Households

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1. (SBU) Summary. The Verkhovna Rada (parliament) reviewed on October 4 the preliminary results of its investigatory commission on NaftoHaz and the natural gas sector. The commission reported multiple instances of mismanagement, malfeasance, and possible criminal acts within state-owned oil and gas monopolist NaftoHaz in 2005-6, and made recommendations to regulate more rigorously the industry and the monopolist. On October 5 the Rada reversed its vote of a week prior which canceled the huge price rises authorized since July. Rada members were persuaded to reverse themselves after Deputy Prime Minister Kluyev promised to reduce the price by 18% from the July level and institute tiered pricing based on consumption. Regional governments will therefore be able to charge \$68/tcm for gas this winter, 94% higher than last year. Consumers remain strongly opposed to the increases and many say they cannot afford them. The GOU's maneuvering underscored the reality of higher energy prices for Ukraine and may have shifted blame for the higher prices from the Yanukovych government to its predecessors, while scoring a few populist points with the 18% price reduction. End Summary.

Commission Finding:
Poor NaftoHaz Management, Questionable Contracts

2. (U) The Verkhovna Rada's Temporary Investigative Commission on the Gas Sector reported on October 4 its preliminary results at a Rada plenary session and promised full results by December 30. Commission Chairman and Socialist MP Andriy Derkach announced that the GOU had lost control of the gas sector in 2005, and that "incomprehensible and unprofessional" NaftoHaz negotiating positions had led to the significant rise in gas prices in January 2006. Derkach noted that evidence of possible malfeasance and other illegal acts had been uncovered and directed to law enforcement for review.

3. (SBU) The commission found the following reasons for NaftoHaz's worsened financial state: a decrease in profits due to the 2005 halt in gas re-exports; a sharp decline in payment discipline; a mistaken NaftoHaz policy of covering working capital deficits with foreign loans; and significant increases in non-production and management expenses. (Comment: Oddly, the Derkach Commission did not list as a reason the reduced revenue that followed NaftoHaz's loss of higher-paying industrial customers to the NaftoHaz-RosUkrEnergo joint venture UkrHazEnergo.) The commission found violations and possible criminal offenses in NaftoHaz's foreign operations and financial management. The majority of contracts for the supply of gas to Ukraine and its transit through Ukraine, according to the Commission, were signed in a non-transparent manner with significant

procedural violations.

Commission Finding:

GOU Can Reduce Residential Gas Price 30%

14. (U) The commission found that, based on cost data supplied by Ukrainian gas producers, the GOU could reduce the residential price of gas by 30% from the July 1 level of 414 UAH/tcm. To protect vulnerable populations from rising gas prices, the Commission recommended establishing a working group to create a new system of subsidies for the 2008 budget. The Commission recommended that all NaftoHaz profits from export, re-export, and transit of gas within Ukraine fund energy price subsidies. (Note: Post is unaware of any current export or re-export of NaftoHaz gas and Gazprom recently reduced its planned 2007 sales volume to NaftoHaz, thus apparently eliminating a portion that could have been re-exported.) The Commission also suggested that the NERC cancel UkrNafta and ChornoMorNaftoHaz's licenses to sell gas at unregulated rates, since according to Ukrainian legislation these state companies should be providing gas to residences at regulated rates.

Commission Recommendation:

Trust No One; Regulate Everyone

15. (SBU) The Commission preliminarily recommended greater government oversight for the sector and for NaftoHaz, to include

-- The National Electricity Regulatory Commission (NERC) and government ministries should verify NaftoHaz rate change recommendations.

-- A special commission from Ukraine's Accounting Chamber should review NaftoHaz gas procurements to ensure the company is purchasing the lowest priced gas.

-- The Ministry of Fuels and Energy should develop a system to review NaftoHaz contracts and agreements before NaftoHaz signs them.

-- The Ministry of Labor should develop a salary matrix for energy sector employees, with bonuses or higher salaries only to be paid from company net profits.

-- The Ministry of Fuels and Energy should ensure the sector adopts international accounting standards.

-- The Cabinet of Ministers should simplify the organizational structure of NaftoHaz.

-- Employment decisions should be based on professional ability, and the Commission recommended reviewing the credentials of current members of Boards of Directors and Supervisory Councils of Ukraine's energy sector state companies, including NaftoHaz and its subsidiaries.

Rada Flip Flops on Gas Rate Rollback

16. (U) Following the investigatory commission's report, the Rada voted on October 5 to invalidate its over-ride of a presidential veto of September 22, which had rolled back gas prices to January 1 levels and imposed a moratorium on future increases (reftel). The October 5 decision was supported by 249 of 436 deputies. Party of Regions, Socialist, and Communist deputies who initially supported the rollback now voted to overturn it, while Our Ukraine deputies who originally opposed the rollback voted to keep it in place. Only Yuliya Tymoshenko Block deputies showed consistency in the two votes, being for the rollback in both instances.

17. (SBU) A major reason for the Rada's reversal on gas prices was a change in the Yanukovich's government's position on gas prices: the Cabinet of Ministers asked the Rada to reverse itself, despite the fact that the majority of ruling coalition MPs had voted for it. Prime Minister Yanukovich said it was too early to lower gas prices, noting that he was not yet confident it would be a "responsible

step." The parliamentary flip flop came after Deputy Prime Minister Klyuev promised to introduce a range of compromise measures, including an 18% reduction in the residential gas price (to 339 UAH/tcm) and a system of tiered pricing based on a family's monthly usage and floor space. Communist Party leader Pyotr Symonenko pointed to the 18% rate reduction specifically in explaining his party's vote switch. (Note: Boyko later announced the 18% reduction had been enacted, effective immediately, after an October 11 CabMin meeting. The tiered pricing Boyko said would begin November 1.)

Local Governments Prepare for Winter Price Rise

18. (U) Across Ukraine, regional governors are preparing their electorates for higher gas prices, which must be set at the local level to coincide with the NERC's increased wholesale price (339 UAH/tcm) for regional distributors. Governors in Zaporizha, Kiev Oblast, Lviv, Odesa and Poltava, as well as Kiev Mayor Chervonitskiy, have spoken out on the need for higher, economically justified rates. Zaporizha, Kherson, Sevastapol, Lviv, Ivano-Frankivsk, Lutsk and Odesa have already raised rates, while Sumy, Luhansk and Karkhiv plan to do so soon. Other major cities have put off the unpopular decision until the last possible moment.

19. (U) Chernovitskiy's Kiev City Administration published a draft resolution on October 10 to triple residential heating and hot water rates. Residents would pay 2.03 UAH/m2/month for heat (up from 0.80 UAH) and 10.72 UAH/m3 for hot water (up from 3.72 UAH). For an average-sized apartment of 50 m2, a household's monthly heating bill would rise from 40 UAH (\$8) to 101.5 UAH (\$20), though Klyuev's price-tier plan, which includes a 20% reduction for families with household sizes of less than 100 m2, would reduce this payment to \$16/month. (Note: Ukraine's minimum wage currently is 375 UAH/month (\$75), while pensions are 366 UAH/month (\$73); a \$16 monthly heat payment is over 20% of a pensioner's income.)

110. (U) A September 15-20 Razumkov Center poll found that 72% of respondents thought high residential gas prices were not justified. 48.5% of respondents blamed the government for the rise in prices, while 19.1% blamed President Yushchenko and 6.7% blamed local government. 14.4% answered that no one was to blame since the prices were based on higher gas prices from Russia. Among respondents who already are paying higher gas prices, 31.3%

responded that their families could not pay the new rates, and 56.9% answered that they could pay, but it would be difficult. Only 5.5% said the higher prices would not cause budget problems. (Note: Until the May and July increases, the GOU had not raised residential gas prices since 1999, aside from increases to cover overall inflation.)

Comment

111. (SBU) The September gas price rollback vote created a minor firestorm in the Ukrainian press and served as a platform to highlight the preliminary findings of the Rada's investigatory commission on the gas sector. The commission's recommendations were heavy on regulatory oversight and allocations, light on transparency and bringing modern management to NaftoHaz, and silent on introducing competition to the sector, which would likely be the only way to effect real reform and growth. The media scrutiny highlighted the reality of higher gas prices, with one sound-bite noting that until recent increases Ukraine was behind only Turkmenistan in having the lowest residential gas prices in the CIS, and in Turkmenistan gas for households was free. While the increase brings residential gas rates here closer to international levels, they remain below wholesale prices for imported gas. Some in the GOU like to argue that they are not selling gas to households at a loss because cheaper domestically-produced gas is "dedicated" to household customers. However, this in turn leads the GOU to depress prices at domestic well-heads, removing an incentive for greater domestic gas production. The commission and media attention may have shifted blame from the sitting Yanukovych government to the previous one, but regardless of who is in the CabMin, increased energy prices will be a bitter pill for Ukraine's most vulnerable

consumers.

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